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EDITORIAL

USURY AND SMALL LOAN LEGISLATION

FEW fields of social legislation have been subject to as bitter prejudice as that governing small loans. Ignorance of the economic basis and the purpose of such legislation has led to a misunderstanding of the situation, not only by laymen, but also by experienced lawyers. To really understand the distinction between small loan charges and usury it is imperative to understand the subject of interest and usury. Although usury was forbidden by the Mosaic Code, and the taking of interest prohibited by the Medieval Church, the common law has for the past four hundred years recognized the power of the state to determine the legal rate of interest for the loan of money.[1] These rates

[1] Statute, 37 Henry VIII, ch.9. authorized a maximum charge of 10% per annum in 1545.

fluctuated according to the circumstances of each transaction, but gradually the English writers recognized the economic nature of the problem and formulated certain general rules which provided that the rate of interest was to be determined, first, by the inconvenience of parting with the money sustained by the lender, and, second, by the hazard, risk, and special expense sustained by the lender.[2] These two economic rules have served as the foundation for modern business practices as well as for modern statutes regulating interest and usury. Consequently, a thorough understanding of the application of these rules to the Wisconsin Statutes will clarify much of the difficulty surrounding the subject of usury.

The Wisconsin legal rate of interest is 6% per annum,[3] but parties can legally contract in writing for the payment of as high as 10% per annum.[4] Yet, although it is legal to charge as high as 10% interest, contracting parties base their interest charges in accordance with the old English rule: first, by the inconvenience of parting with the money, and, second, by the hazard, risk, and special expense sustained. Thus loans of money on bonds of the United States Government bear only 3% interest per annum because there is no risk sustained by the lender; loans to sound corporations on gilt-edge bonds bear 6% interest because the risk is moderate; and loans to speculative enterprises bear as high as 10% interest because the risk is great. But there are certain circumstances when the risk is so great that the lender cannot make the loan and safeguard himself without demanding more interest than the law permits. Such taking of more interest for the use of money than the law allows is usury.[5] In order for usury to exist there must be:

1. A loan or forbearance either express or implied.[6]
2. A loan or forbearance of money or of something circulating as such.[7]
3. An understanding between the parties that the principal shall be repayable absolutely.[8]

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[2] Chase's Blackstone, ch. 455.

[3] Wis. Statutes 1931. Ch. 115.04.

[4] Wis. Statutes 1931. Ch. 115.05.

[5] Lee v. Peckham, 17 Wis. 383; Fay v. Lovejoy, 20 Wis. 407; Case v. Fish, 58 Wis. 56, 15 N.W. 808; Harman v. Lehman, 85 Ala. 379, 5 So. 197; Re Mansfield Steel Corp. 30 Fed. (2d) 832; Cammack v. Runyan Creamery, 175 Ark. 601, 299 S.W. 1023; Hatcher v. Union Trust Co. 174 Minn. 241, 219 N.W. 76; Barnhart v. Richardson, 134 Okla. 19, 272 Pac. 418; Independent Lumber Co. v. Gulf State Bank (Tex. Civ. App.) 299 S.W. 939.

[6] Levy v. Gadsby, 3 Cranch. 180, 2 U.S. (L. Ed.) 404; Scott v. Lloyd, 9 Pet. 418, 9 U.S. (L. Ed.) 178.

[7] Title Guaranty etc. Co. v. Klien, 178 Fed. 689, 102 C.C.A. 189.

[8] White Water Val. Canal Co. v. Vallette, 21 How. 414. 16 U.S. (L. Ed.) 154. Braynard v. Hoppock, 32 N.Y. 571, 88 Am. Dec. 349.

4. An exaction of greater profit than is allowed by the law.[9]
5. An intention to violate the law.[10]

The Wisconsin law today, except as modified by the Small Loans Act, makes it usurious to charge a rate in excess of 10 per cent per annum;[11] the lender of a usurious loan is able to recover only his principal,[12] and is guilty of a misdemeanor subject to fine, or imprisonment, or both.[13] And where the borrower pays interest in excess of the maximum rate, he can recover treble the amount above the maximum rate, provided that he bring his action within one year after payment.[14]

The Wisconsin Statutes thus outlawed all loans charging a rate of interest higher than 10% per annum. But mere legal dictates cannot in the long run survive against economic law. The legislation prohibiting usury was satisfactory as long as Wisconsin remained essentially a rural state. For under the rural economic conditions of fifty years ago, the masses of people were supported on the land in an environment which did not make the necessity for a sudden small loan a matter of common occurrence.[15]

But with the shift of population to large cities where families had no other source of support than money, usury was inevitable. The emergencies of urban life, demanding sudden expenditures of cash, placed the average man with an income of less than $1800 a year[16] in an almost hopeless condition. In need of money, he lacked the security necessary for a bank loan;[17] and was too poor a risk to obtain a loan from reputable companies at the maximum legal rate of 10% per annum. The hazard, risk, and special expenses sustained by the lender in such a case would be so great as to make the loan prohibitive.[18] Consequently, men in need of money were driven to small loan sharks who operated outside the pale of the law and charged rates ranging

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[9] Missouri, etc. Trust Co. v. Krumseig, 172 U.S. 351, 19 S. Ct. 179.

[10] Milw. First Nat. Bank v. Plankinton, 27 Wis. 177; Grant v. Merrill, 36 Wis. 390; Call v. Palmer, 116 U.S. 98, 6 S. Ct. 301; Lassmann v. Jacobson, 125 Minn. 218, 146 N.W. 350; Condit v. Baldwin, 21 N.Y. 219, 78 Am. Dec. 137.

[11] Wis. Statutes 1931. Ch. 115. 05.

[12] Wis. Statutes 1931. Ch. 115. 06.

[13] Wis. Statutes 1931. Ch. 115. 07, (2).

[14] Wis. Statutes 1931. Ch. 115. 07, (1).

[15] Cf. Tugwell, Munro, Stryker, "American Economic Life" pp. 8-64. It is significant that the twelve states which have no small loan legislation are with the exception of Kentucky very rural in nature.

[16] U. S. Bureau of Labor Statistics show that 82% of population have an annual income of less than $1800, period used—1919-1929.

[17] Ref. "Findings and Conclusions of the Citizens Research Committee on the Wisconsin Small Loan Law of 1927."

[18] Cf. ibid.

from 120% a year to 1300% a year.[19] The laws prohibiting usury not only broke down, but also aggravated the situation by preventing honest brokers from lending sums at rates which would be much lower than those of the sharks, although in excess of the legal rate of 10% To remedy this evil, Wisconsin, in 1895, passed an act which legalized a rate of interest of 10% plus fees and charges of an additional 14% a year on loans secured by chattel mortgages.[20] In 1913 the rate of 24% was reduced to a total rate of 14% a year,[21] and in 1915, increased to 17% for loans under $100.[22]

The failure of these rates to attract enough capital into the small loan field to drive out the shark and serve the needs of the people finally led to the adoption of the Uniform Small Loans Act by Wisconsin in 1927.[23] The essential features of this Act are:

1. Licensing of small loan companies by the commissioner of banking.[24]
2. Lending of loans of less than $300 at 3½% interest per month, not to be compounded, and to be computed only on unpaid balances, with no other fees or charges.[25]
3. Inclusion of assignment or sale of wages within provisions of Act.[26]
4. Punishment of violation of Act as misdemeanor, by fine, or imprisonment or both, with forfeiture of both principal and interest in case of overcharge.[27]

At first sight it must appear that this Act is incompatible with the Wisconsin statute limiting 10% as the maximum rate of interest per year. Closer analysis, however, will show that the two sections are entirely reconcilable, and a modern adaptation of the economic rule so long recognized in England which determined the rate of interest, first, by the inconvenience to the lender, and, second, by the risk, hazard, and

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[19] Gallert, Hilborn, and May, "Small Loan Legislation," 1932. p. 54. Brandt v. Hall, 40 Ind. App. 651; Tennessee Finance Co. v. Thompson, 278 Fed. 597; Cotton v. Cooper, 160 S.W. (Texas 1913) 597; State v. Hurlburt, 82 Conn. 232; Willson v. Fisher, 75 Misc. (N.Y.) 383; In re Home Discount Co. 147 Fed. 538. 42 Harv. L. R. 689. 8 J. Crim. L. 69.

[20] Laws 1895, ch. 327.

[21] Session Laws 1913, ch. 115.

[22] Session Laws 1915, ch. 450.

[23] Laws 1927, ch. 450. Wisconsin Statutes 1931, Ch. 214.

[24] Wis. Statutes 1931, Ch. 214.01—214.11.

[25] Wis Statutes 1931, Ch. 214.13.

[26] Wis. Statutes 1931, Ch. 214.17. Section 16 of Uniform Small Loan Act. Constitutionality upheld in Palmore v. Baltimore & Ohio Ry. Co. 142 Atl. (Md.) 495; Sweat v. Comm. 148 S.E. (Va.) 774; Dunn v. State, 173 N.E. (Ohio) 22; Service Purch. Co. v. Brennan, 42 S.W. (2nd) 39

[27] Wis. Statutes 1931, Ch. 214.13 and Ch. 214.19.

expense sustained. The modern law is excellently stated in the case of Hatcher v. Union Trust Co. 174 Minn. 241, 219 N.W. 76, (1928).

"The general rule is that a loan is not rendered usurious by the fact that the borrower is required to pay a reasonable compensation in excess of interest for services and expenses and expenditures incurred by the lender in connection with the loan, where there is no intent to evade the law, and the required payment does not result in giving to the lender a greater return for the use of the money than is allowed by law. Expenses incident to making the loan and furnishing the lender satisfactory security for its repayment can in no sense be considered compensation for the use of the money loaned."

Further illustration of this same point is given in the case of Friedman v. Wis. Acceptance Corp. 192 Wis. 58, 210 N.W. 821, (1926) in which the court held that a contract for a loan on an automobile, whereby the lender charged the highest legal rate of interest and then added $21 for insurance on the car, was not usurious because the cost of insurance was a special necessary expense for the making of the loan, benefiting the borrower as much as the lender.[28]

The adaptation of these holdings to the Small Loans Act is just this: the average person applying for a small loan is such a poor risk that the loan company must secure in addition to the 10% interest per year to which is is legally entitled, an added payment to cover the expenses of investigating the applicant, the expenses of administering the loan, the expenses of collecting the monthly payments, and other costs peculiar to the loan. Experience in twenty-five states has shown that this 10% interest plus other necessary expenses will total 3½% a month. But it does not follow that a loan of $100 will bear $42 interest for one year, inasmuch as a fraction of the loan is paid off each month and the interest runs only on the unpaid balance. Actually if one-twelfth of the $100 were paid off each month plus the interest due on the unpaid balance, the cost of the loan for one year would be $22.75.[29]

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[28] Same holding in: Niles v. Kavanagh, 179 Cal. 98, 175 Pac. 462; Homeopathic Mut. L. Ins. Co. v. Crane, 25 N.J. Eq. 418; Matthews v. Georgia State Sav. Asso. 132 Ark. 219, 200 S.W. 130. New England Mortg. Secur. Co. v. Gay, 33 Fed. 636. Blanchard v. Hoffman, 192 N.W. 352, 154 Minn. 525. Brown v. Robinson, 120 N.E. 694, 224 N.Y. 301. Van Dyk v. Dujardin, 210 N.Y.S. 737, 213 App. Div. 791. Also see: O'Toole v. Meysenburg, 163 C.C.A. 347, 251 F. 191. M. Lowenstein & Sons v. British Amer. Mfg. Co. 300 F. 853. Cain v. Stacy, 232 Mich. 548, 205 N.W. 592. Joy v. Provident Loan Society, 37 S.W. (2nd) 254. Cotton v. Cooper, 209 S.W., 135.

[29] Cf. Wis. Atty. Gen. Opinions Vol. XX. p. 1083. "It is illegal under Small Loans Act for small loans companies to compute the total interest on $300 loan for one year at the rate of 3½% a month, add this sum to the total amount of the loan, and then divide this sum into twelve monthly payments."

Yet although the courts hold that the special necessary expenses for a loan may be added to the maximum interest rates, the distinction is made between necessary expenses and fees used as a cloak for usury. In cases where the lender seeks to extract a usurious rate through charges for fictitious services, the court will disregard the form of the contract and judge it only by its substance. Thus in Dayton v. Dearholt, 85 Wis. 151, 55 N.W. 147, the court held:[30]

"It is entirely immaterial in what manner or form or under what pretense the usury was exacted or paid. The contract will not be held good merely because upon its face and by its words it is free from taint, if substantially it be usurious. Courts look at the substance of the transaction without regard to the shifts by which it is endeavored to avoid the provisions of the statute."

Small Loan Acts have been repeatedly attacked as being unconstitutional, and while it is not within the scope of this article to write in detail on the constitutionality of the Act, it is suffice to say that the courts of the land have repeatedly held the Act constitutional on the ground that the regulation of the business of making small loans is within the police power of the state inasmuch as the small loan business is a public necessity and its regulation is necessary for the public welfare.[31]

In conclusion, it can be said that although Small Loan legislation has markedly improved the character of the personal finance business in America, while it has served to supplant criminal loan sharks with reputable corporations, there is still room for improvement in the situation. Legislation in the future will undoubtedly concern itself with stricter licensing of small loan companies as provided in the latest draft (the fifth) of the Small Loan Act, sponsored by the Russell Sage Foundation, and with more careful attempts to reduce rates.[32]

At present competition between the larger companies has served to reduce the rates below the maximum rate of 3½% per month. The amount of these reductions has varied according to how economic con-

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[30] Accord: Towslee v. Durkee, 12 Wis. 480; Durkee v. City Bank, 13 Wis. 216; Rock County Bank v. Wooliscroft, 16 Wis. 22; Wis. Cent. Bank v. St. Johns, 17 Wis. 157; Cornell v. Barnes, 26 Wis. 473. Also: Service Purchasing Co. v. Brennan. 42 S.W. (2d) 39.

[31] Cf. "The Constitutionality of Small Loan Legislation" by F. R. Hubachek. 1931. Law held constitutional in: People v. Stokes, 281 Ill. 159, 118 N.E. 87; Badger v. State, 154 Ga. 443, 114 S.E. 635; Warner v. People, 71 Colo. 559, 208 Pac. 459. Regulation of small loans within police power of state: State ex rel. Ornstine v. Cary, 126 Wis. 135, 105 N.W. 792; Fahringer v. State, 148 Wis. 291, 134 N.W. 406; Griffith v. Conn. U.S. 563, 31 S Ct. 132; Re Home Discount Co. 147 Fed. 538; Dewey v. Richardson, 206 Mass. 430, 92 N.E. 708.

[32] Section 4, Uniform Small Loans Act, Fifth Draft.

ditions affect the net incomes of the companies involved. Future reforms will direct themselves toward vesting the licensing body with the power to fix rates of operating companies at a point just high enough to attract sufficient commercial capital to meet the needs of the small loan business in Wisconsin and to classify loans according to size or in some other manner and to vary the rates applicable to each class, so as to leave no class of loans carrying more than its proportionate share of the cost. This results in treating the field of personal finance in somewhat the same manner as that of public utilities.[33]

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[33] Cf. Dewey v. Richardson, 206 Mass. 430, 92 N.E. 708. 36 Harv. L. R. 405.